



HONG KONG MONETARY AUTHORITY

香港金融管理局

Our Ref: B1/15C
G16/1C

30 October 2018

The Chief Executive
All Registered Institutions

Dear Sir / Madam,

Sale and Distribution of Debt Instruments with Loss-absorption Features and Related Products

Further to the circular on “Distribution of Fixed Income and Structured Products” issued on 8 February 2018 and the “Consultation Conclusion on Rules on Loss-absorbing Capacity Requirements for Authorized Institutions” published on 25 July 2018 by the Hong Kong Monetary Authority (HKMA), I am writing to provide guidance on enhanced investor protection measures on sale and distribution of debt instruments with loss-absorption features and related products.

Debt instruments with loss-absorption features are subject to the risk of being written down or converted to ordinary shares (such as recapitalising the issuer as it goes through resolution), potentially resulting in a substantial loss to the investors concerned. The circumstances in which these debt instruments may be required to bear loss are difficult to predict and ex ante assessments of the quantum of loss will also be highly uncertain. Hence, debt instruments with loss-absorption features are inherently complex and are of high risk, and are generally not suitable for retail investors.

Applicability

The requirements below apply to the primary and secondary market sale and distribution of the following products (referred to as “Loss-absorption Products”):

- (i) debt instruments with features of contingent write-down or conversion to

ordinary shares on the occurrence of the following:

- (a) when a financial institution is near or at the point of non-viability; or
- (b) when the capital ratio of a financial institution falls to a specified level.

For the avoidance of doubt, plain vanilla debt instruments and deposits (including certificates of deposits) are not captured as “Loss-absorption Products” for the purpose of applying the enhanced investor protection measures as set out in this circular.

and

- (ii) investment products that invest mainly in, or whose returns are closely linked to the performance of, instruments described in (i) above (for example, collective investment schemes which invest more than 50% of net asset value in instruments described in (i) above, or structured products whose returns are closely linked to the performance of instruments described in (i) above).

(A) Selling restrictions

Registered Institutions (RIs) should stay vigilant and sell and distribute Loss-absorption Products only to professional investors (PIs), as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance, in both primary and secondary markets.

(B) Product risk rating

Loss-absorption Products should be regarded as complex and high risk. When conducting product due diligence, RIs should take this into account and assign appropriate product risk ratings. In this respect, RIs should treat non-leveraged investment in these products as of at least high risk, and leveraged investment (i.e. transactions conducted by a customer on a margin basis) as of the highest risk.

(C) Suitability assessment

RIs should assure themselves that customers who wish to invest in Loss-absorption Products have adequate knowledge or experience in products with contingent write-down or contingent convertible features.

RIs should ensure that a transaction in Loss-absorption Products is suitable for the customer in all the circumstances, irrespective of whether there is any

solicitation or recommendation to the customer. Given the nature and riskiness of Loss-absorption Products, RIIs are expected not to allow any risk-mismatch in such transactions¹, and that a strong justification would be needed for any such exceptional transactions. RIIs are reminded that mere mechanical matching of an investment product's risk rating with a customer's risk tolerance level may not be sufficient to discharge their suitability obligations. They should give due consideration to all relevant circumstances specific to a customer, including concentration risk, when performing suitability assessment.

(D) Disclosure of product information

- (i) RIIs should direct a potential customer of a Loss-absorption Product in primary and secondary markets to any selling restrictions (e.g. sale and distribution to PIs only) and key warning statements in the offering and product documents. RIIs should explain to the customer relevant information and warnings, such as key product nature, features and risks.
- (ii) RIIs should provide sufficient relevant information to a customer, in particular:
 - the product is subject to the risk of being written down or converted to ordinary shares (as the case may be);
 - the circumstances that the contingent write-down or conversion may happen, and the implications to investors (including that it may potentially result in a substantial loss);
 - it is a high risk product;
 - it is a complex product, as the circumstances in which the product may be required to bear loss are difficult to predict and ex ante assessments of the quantum of loss will also be highly uncertain;
 - the product is targeted at PIs only, and is generally not suitable for retail investors; and
 - credit ranking (e.g. subordinated) and implications to investors.

Exemptions for PIs²

RIIs dealing with Institutional PIs are automatically exempted from the above enhanced investor protection measures as set out in (B), (C) and (D)(i). RIIs

¹ Referring to a transaction in which the risk tolerance level of a customer is lower than the risk rating of the investment product being purchased.

² “Institutional PIs”, “Corporate PIs” and “Individual PIs” as defined in the SFC’s “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission”.

dealing with Corporate PIs could be entitled to same exemptions as applied to Institutional PIs, provided that RIIs have complied with paragraphs 15.3A and 15.3B of the SFC's "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission". RIIs dealing with Individual PIs should observe all the requirements set out in this circular without any exemptions.

Implementation arrangements

RIIs should implement the requirements as set out in this circular as soon as possible, but no later than 6 April 2019. In case an individual RI has strong justifications that more time is needed for implementation, it may approach the HKMA for discussion. For the avoidance of doubt, for Loss-absorption Products that were issued before the date of this circular, the enhanced investor protection measures, including selling restrictions, in this circular will be applicable to future sale and distribution in the secondary market by RIIs.

Senior management of RIIs should review and put in place adequate policies, procedures and controls to ensure compliance with this circular and other relevant requirements and standards, and provide sufficient training and guidance to relevant staff. The HKMA will monitor RIIs' compliance as part of our on-going supervision.

If you have any questions on this circular, please contact Ms Ada Au at 2878-8814 or Ms Florence To at 2878-1582.

Yours faithfully,

Alan Au
Executive Director (Banking Conduct)

c.c. SFC

(Attn: Ms Julia Leung, Deputy Chief Executive Officer and Executive Director (Intermediaries) and
Ms Christina Choi, Executive Director (Investment Products))